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In the Supreme Court of the United States

OCTOBER TERM, 1933.

No. 225

DAVID BURNET, Commissioner of Internal Revenue,

Petitioner,

vs.

OTTO H. FALK, et al., Executors of the Estate of Charles F. Pfister, Deceased.

On Petition for a Writ of Certiorari to The United States Circuit Court of Appeals for the Seventh Circuit.

BRIEF FOR THE RESPONDENTS IN OPPOSITION.

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Statement.

To the facts stated in the petition the following, taken from the stipulated facts should be added:

After providing for the payment of taxes and necessary expenses incident to administration, including compensation for the trustee, the trust deed provided:

Except as above authorized to be expended, paid out or retained, all proceeds which shall come to the hands of the Trustees from said property or from any use which may be made thereof, or from any source whatsoever hereunder, as received by the Trustee *shall belong to and be the property of the beneficiaries hereunder* to be distributed and paid over to them in proportion to and in accordance with their respective interests as shown herein (R. 98, 99, 100).

If *as matter of law* the beneficiaries of the trust are entitled to an allowance for depletion, it was stipulated that the life of the mine for the purposes of the determination of the amount of the allowance was nine years from the basic date, November 29, 1916, and the amount of the allowance $.13255 per ton of ore mined (R. 99, 100).

The mining lease extended for a period exceeding the life of the mine as fixed for the purposes of depletion allowances, and the term of the trust exceeded the term of the lease and the life of the mine.

Question Involved.

The petition states that the question presented is,

> "Whether the beneficiaries of a trust who have no interest in the trust corpus are entitled to a deduction for depletion of a mineral property constituting the corpus of the trust."

If that is the question intended to be presented by the petition, it is not the question presented by the facts of the case or upon which the decision of the Court below was based. Upon the facts presented the Court below held that the beneficiaries of the trust did have such an interest in the trust corpus as entitled them to deductions for depletion under the statute. *64 Fed. (2) 171, 172.*

Argument.

Under the peculiar conditions in this case the beneficiaries of the trust are clearly within the terms and implications of the statute requiring deductions for depletion.

Section 214 (a) of the Statutes, 1921, 1924 and 1926 Acts, provides that in computing net income there shall be allowed as deductions "* * * (10) In the case of mines * * * a reasonable allowance for depletion * * * according to the peculiar conditions in each case * * *"

It is argued in the brief for petitioner that because these provisions do not specify beneficiaries of trusts as entitled to the deduction they are excluded from the allowance. But they do not specify *who is entitled to the deductions.* The necessary implication is that all who are subject to the tax on the proceeds of the mining operation that results in the exhaustion of the ore reserve from which the proceeds are derived are entitled to the deduction in accordance with their respective interests. The trustees in this case are in the position of the lessors of the mine. They cannot take the deduction that pertains to the interest of the owner of the ore reserve, because they are not subject to the tax upon the royalties. By the express terms of the trust instrument all property rights in the royalties less necessary expenses of administering the trust pass to the beneficiaries coincident with their receipt by the trustees who are required to distribute them accordingly as and when they are received. With respect to the royalties which are the subject of the tax and from which the deduction for depletion on account of the owners' interest in the ore reserve must be taken, the trustees act merely as dis-

tributing agents. If the beneficiaries who receive them at the hands of the trustees and are subject to the tax are not entitled to deductions for depletion then there can be no deduction on account of the depletion of the owner's interest in the ore reserve by the operations under the lease. The statute does not permit of any such unreasonable construction.

The provision of the 1928 Act, sec. 23 (1), impliedly refutes the contention of the petitioner that the corresponding provision of previous Acts excluded beneficiaries under trusts from the allowance. The provision of the 1928 Act reads as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each."

It will be noted that the first sentence of this section which grants the right to an allowance for depletion is the same as in previous Acts. What follows presupposes the application of the first sentence to the cases specified and provides how the allowance shall be apportioned in those

cases. The provisions referring to the specified cases are administrative only, making clear for purposes of administration that would otherwise be left to construction. The view of Judge Manton in the *Merle-Smith* case that this section was declaratory of the law as it already existed in prior enactments (*42 Fed. (2)* p. 842), was obviously correct.

II.

The question sought to be raised by the petition is foreclosed by decisions of this court.

Lynch vs. Alworth-Stephens Co., 267 U. S. 364; *U. S. vs. Ludey*, 274 U. S. 295; *Bryant vs. Kennett*, 113 U. S. 179; *Croxall vs. Sheperd*, 5 Wall. 268; *Irwin vs. Gavit*, 268 U. S. 161; *Merle-Smith vs. Com'r of Internal Revenue*, 42 F. (2) 837, certiorari denied by this court, 282 U. S. 897; *Palmer vs. Bender*, 53 S. C. 225, decided January 9, 1933; *Bankers Pocahontas Coal Company vs. Burnet*, 53 S. C. 150, decided Dec. 5, 1932.

In *Palmer vs. Bender*, 53 S. C. 225, decided January 9, 1933, the court said:

> "That the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted was recognized by this Court in Lynch vs. Alworth-Stephens Co., 267 U. S. 364, 45 S. Ct. 274, 69 L. Ed. 660. There a depletion allowance under section 12(a) of the 1916 act, 39 Stat. 767, was claimed by a lessee of a mining lease, in the computation of tax on income from the proceeds of ore mined. *The statute made no specific reference to lessees,* and the government argued that, as the lessee acquired no ownership of the ore until the severance from the soil (see United States vs. Biwabik Mining Co., 247 U. S. 116, 123, 38 S. Ct. 462, 62 L. Ed. 1017) the

lease gave him no depletable interest in the ore in place. But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease. Depletion was therefore allowed.

"Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if by virtue of the leasing transaction he has retained a right to share in the oil produced. If so, he has an economic interest in the oil, in place, which is depleted by production. Thus we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals in place passed from the lessor upon the execution of the lease. See Burnet vs. Harmel, supra; Bankers' Pocahontas Coal Company vs. Burnet, 287 U. S. , 53 S. Ct. 150, 77 L. Ed. , decided December 5, 1932." (pp. 226 and 227.) (Italics ours.)

In *Irwin vs. Gavit*, 268 U. S. 161, 167, it was said:

"A gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities, we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it."

A fortiori the right to receive a portion of the proceeds from the removal and sale of ore in place in a mine gives to the recipient an interest in the ore reserve, regardless of how the legal title to the ore reserve may be held.

"In the consideration of a court of equity, the *cestui que trust* is actually seized of the freehold. He may alien it, and any legal conveyance by him will have the same operation in equity upon the trust, as it would have had at law upon the legal estate.

The trust like the legal estate is descendible, devisable, alienable, and barrable by the act of the parties, and by matter of record. Generally, whatever is true at law of the legal estate, is true in equity of the trust estate."

Croxall vs. Shepard, 5 Wall. 268, 281.

In *Bryan vs. Kennett*, 113 U. S. 179, the Court said:

"The term 'property' as applies to lands, comprehends every species of title, inchoate or complete." * * * By the term 'property' applied to lands all titles are embraced, legal or equitable, perfect or imperfect."

In *Lynch vs. Alworth Stephens Co.*, 267 U. S. 364, the Court said:

"There is nothing [in the Revenue Act] to suggest that the word 'property' is used in any restricted sense * * *."

"The plain, clear and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to every one whose property right and interest therein has been depleted by the extraction and disposition 'of the product thereof which has been mined and sold during the year for which the return and computation are made.' And the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover"

"It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and own-

> ership is property within the meaning of the general provision. Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each case is to be arrived at in the same way, namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each severally considered" (p. 370).

In the language of Judge Manton in the *Merle Smith* case, the beneficiaries *in the instant cases*,

> "have a property right and interest, within the decision of Bryan vs. Kennet, 113 U. S. 179, 5 S. Ct. 407, 28 L. Ed. 908, as real as that of the lessee referred to in Lynch vs. Alworth-Stephens Co., supra." (*42 Fed. (2)* at p. 840.)

The *Merle-Smith* case was not decided on the ground of the remainder interests involved but on the ground that it was the intention of Congress to exempt from the tax in the determination of taxable income the portion of the proceeds of the mining operation which may be regarded as a return of capital (*42 Fed. (2)* at pp. 840-842). The decision of the case on that ground is amply supported by the decisions of this Court.

Thus in *U. S. vs. Lidey*, 274 U. S. 295, 303, the court said:

> "The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material

in making the product of a manufacturing establishment. As the cost of the raw material must be deducted from the gross income before the net income can be determined, so the estimated cost of the part of the reserved used up is allowed."

* * * * *

"The Corporation Tax Law of 1909 (36 Stat. 112) had failed to provide for any deduction on account of the depletion of mineral reserves. Stratton's Independence vs. Howbert, 231 U. S. 399, 34 S. Ct. 136, 58 L. Ed. 285; Von Baumbach vs. Sargent Land Co., 242 U. S. 503, 37 S. Ct. 201, 61 L. Ed. 460; United States vs. Biwabik Mining Co., 247 U. S. 116, 38 S. Ct. 462, 62 L. Ed. 1017; Goldfield Consolidated Mines Co. vs. Scott, 247 U. S. 126, 38 S. Ct. 465, 62 L. Ed. 1022. The resulting hardship to operators of mines induced Congress to make provision in the Revenue Law of 1913 (38 Stat. 114, 167) and all later acts for some deduction on account of depletion in determining the amount of the taxable income from mines."

In *Bankers Pocahontas Coal Co. vs. Burnet*, 53 S. Ct. 150, decided December 5, 1932, referring to the facts of that case, this court said:

"The applicable statutes thus construed and applied do not tax any part of petitioner's capital investment before March 1, 1913. Section 234 (a) (9) of the Revenue Act of 1918, c. 18, 40 Stat. 1057, 1077, and regulations under it, require depletion allowances upon bonus and royalty payments received by the lessor of mineral lands, *sufficient to provide for a return in full of his invested capital*" (pp. 150, 151) (Italics ours).

The decisions of all of the other lower courts in which the question was involved are in accord with the decision of the court below in this case.

Merle-Smith vs. Com'r of Int. Revenue, 42 F. (2) 837.

Com'r of Int. Revenue vs. Molter, 60 F. (2) 498.

Cooper vs. Reynolds, 60 F. (2) 650.

Assuming that the remainder interests involved, were the decisive factor in the decision of the Court of Appeals in the *Merle-Smith* case, that does not alter the effect of the denial by this court of *certiorari*, as a controlling precedent in this case. Upon the facts stipulated in this case no remainder interest in the ore reserve is involved. It was stipulated that the life of the mine was nine years from November 29, 1946 (Rec. 99). The term of the mining lease exceeded the life of the mine and the term of the trust exceeded that of the mining lease. On the hypothesis upon which the allowance for depletion was computed there would be no remainder interest in the ore reserve after the expiration of the lease and the term of the trust.

It is said in the brief for petitioner that it was not shown that the mineral body was in fact exhausted before the lease expired (p. 14). But the term of the lease was for upwards of 14 years from November 29, 1916, extending at least four years beyond the last of the years here involved (1926). It cannot be assumed that the mineral body would not be exhausted within the term of the lease which was upwards of 14 years, when it was stipulated for the purposes of the depletion allowance that the life of the mine was only nine years. The question of the remainder interest is, however, wholly immaterial in any event. If a possible remainder interest can defeat the right of the beneficiaries to depletion in this case, it should have defeated the right of the lessee to claim depletion in the *Allworth Stephens Co.* case in which this court held that the lessee was entitled to the deduction. All that is said by counsel for petitioner as to the possibility of the ore reserve not being exhausted during the term of the lease in this case is equally applicable to the *Allworth-Stephens Co.* case which was decided contrary to the petitioner's contentions here.

III.

The cases relied on by petitioner are without application.

Anderson vs. Wilson, 289 U. S. 20, did not involve the application of the statute providing for depletion and is plainly inapplicable. The other cases relied on in petitioner's brief relate to ordinary depreciation and likewise did not involve the construction or application of the statute relating to depletion as distinguished from ordinary depreciation. Their lack of application is shown by what is said in the *Merle Smith* case with reference to *Harburghe vs. U. S.*, 64 Ct. Cls. 223, one of the cases relied on by petitioner. As said by Judge Manton with reference to that case:

> "* * * the plaintiff was merely a beneficiary entitled only to income of the trust created for her life. She had no interest in the corpus. The distribution to be made to her from the trust included nothing which could be considered as a part of the corpus. The taxpayer claimed a right to deduct the allowance provided by the act for the depreciation of the properties constituting the corpus of the trust. The difference between that case and the one at bar is that the intention of Congress as to depletion seems to be clear by the act. There is a direction in this trust to distribute to the petitioners not only income from the mining properties, but also a portion of what Congress has considered part of the capital, a part of the corpus of the trust" (*42 Fed. (2)* at pp. 841-842).

In the instant case, the trustees not being chargeable with the tax upon the royalties and having no authority to set aside any portion thereof for a depletion reserve, could not take the deductions for depletion. In their fiduciary returns they made claim for depletion at the proper

rates for the benefit of the beneficiaries, the taxpayers. They could do no more. If they had been entitled under the terms of the trust conveyance to withhold a reserve for depletion, the distribution of this reserve, obviously would not have been taxable income. No more was it when it was distributed to the beneficiaries of the trust currently as it was received as required by the trust instrument.

In conclusion it is respectfully submitted that the question presented by the petition is not an open question under the decisions of this court, and as there is no division in the decisions of the lower courts upon the question there is no reason for a writ of certiorari.

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